

1 THE HONORABLE JOHN C. COUGHENOUR
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UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF WASHINGTON
AT SEATTLE

9 IN RE ZILLOW GROUP, INC.
10 SHAREHOLDER DERIVATIVE
LITIGATION

11 THIS DOCUMENT RELATES TO:
ALL ACTIONS

Master File No.: 17-cv-01568-JCC

DEFENDANTS' MOTION TO DISMISS
THE VERIFIED CONSOLIDATED
SHAREHOLDER DERIVATIVE
COMPLAINT

NOTE ON MOTION CALENDAR:
November 8, 2019

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26 DEFENDANTS' MOTION TO DISMISS THE
VERIFIED CONSOLIDATED
SHAREHOLDER COMPLAINT
(No. 17-CV-01568-JCC) –

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INTRODUCTION

Plaintiffs brought this putative shareholder derivative action on behalf of Zillow Group, Inc. against seven members of Zillow’s current Board of Directors, one former director, and one of its former officers. This suit followed closely on the heels of the securities class action filed in early September 2017 alleging that Zillow and two of its officers made misleading statements about the company’s compliance with the Real Estate Settlement Procedures Act (“RESPA”). *In re Zillow Grp., Inc. Sec. Litig.*, No. 2:17-cv-01387-JCC (W.D. Wash.). Although this Court held that the plaintiffs stated a claim in that case, this one fails because plaintiffs have not come close to adequately pleading that a demand for suit on Zillow’s Board would have been futile.

This action is governed by Washington law (Zillow is a Washington corporation), which follows Delaware’s law on the standards applicable to shareholder derivative suits. Under Delaware law, a plaintiff lacks standing to sue on behalf of a corporation unless he has made either a demand on the corporation’s board to sue the company or a particularized showing that such a demand would be futile because a majority of directors are “incapable of making an impartial decision regarding the pursuit of the litigation.” *Wood v. Baum*, 953 A.2d 136, 140 (Del. 2008). This stringent requirement “is a recognition of the fundamental precept that directors manage the business and affairs of corporations”—including their decisions as to whether to bring a lawsuit. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000). Plaintiffs have not demanded that Zillow’s Board bring a suit, so their ability to bring their own action depends on demand futility.

At the time the initial complaint was filed,¹ there were eight directors on the Zillow Board. Two of the directors are employed by Zillow and another is a director who was an employee of Zillow within the last year. For purposes of this motion only, we do not contend that these three directors are independent. Five are outside directors, one of whom joined the Board in early 2017

¹ Demand futility is gauged at the time of commencement of a derivative suit. *See In re Cray, Inc.*, 431 F. Supp. 2d 1114, 1121 (W.D. Wash. 2006).

1 and plaintiffs concede is independent and disinterested. That leaves four directors in dispute.
 2 Plaintiffs do *not* claim that these directors participated in the alleged fraud. Instead, they allege
 3 that these directors are conflicted for two alternative reasons: (1) they face a “substantial
 4 likelihood” of personal liability for the wrongdoing alleged in the complaint and the securities case
 5 and (2) they have “business entanglements” with other directors preventing them from properly
 6 considering a demand. Both theories fail.

7 First, plaintiffs have failed to adequately plead that any one of the outside directors faces a
 8 substantial likelihood of liability. “Delaware courts have routinely rejected the notion that board
 9 members can be presumed substantially liable for misconduct occurring at the company absent
 10 particularized allegations evidencing that the Board knew about the illicit activities.” *In re BofI*
 11 *Holding, Inc. S'holder Litig.*, 2017 WL 784118, at *15 (S.D. Cal. Mar. 1, 2017) (collecting cases).
 12 Yet plaintiffs base their claim almost entirely on the class action complaint, which was *not* directed
 13 at the four outside directors at issue in this motion. Plaintiffs also accuse the outside directors of
 14 failing to properly supervise Zillow’s management—a theory the Supreme Court of Delaware has
 15 recognized is “possibly the most difficult theory in corporation law upon which a plaintiff might
 16 hope to win a judgment,” *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959, 967 (Del. Ch.
 17 1996)—but they offer no explanation as to how or why any of Zillow’s outside directors would
 18 have *known* whether the conduct at issue was allegedly unlawful and consciously failed to take
 19 action. Instead, plaintiffs simply point to the directors’ duties and claim that because Zillow
 20 allegedly committed securities fraud, the directors must have been complicit. This is exactly the
 21 kind of circular theory that Delaware law forbids.

22 Second, the complaint does not make any particularized allegations that the outside
 23 directors personally profited from the alleged wrongdoing or were dominated by the Zillow
 24 officers who supposedly planned and carried out the alleged fraud. Plaintiffs allege only that the
 25 directors shared outside business relationships with one another. Courts have routinely rejected
 26

1 this sort of “entanglement” theory—recognizing that just about all directors are bound to have
 2 *some* kind of business relationships with officers of the company that they direct.

3 Because plaintiffs have failed to plead demand futility, the complaint should be dismissed.

4 **BACKGROUND**

5 Zillow is a NASDAQ-listed company that provides e-commerce services to homeowners,
 6 buyers, sellers, renters, and real estate professionals throughout the United States. Compl. ¶ 3.
 7 Among other things, Zillow sells advertising on various websites—including zillow.com and
 8 streeteasy.com—to real estate agents and mortgage professionals. *Id.* ¶ 43. Zillow’s customers
 9 may obtain a special “suite” of products by paying additional fees to become “Premier Agents.”
 10 *Id.* ¶ 48. These products include a “co-marketing program,” under which real estate agents may—
 11 but do not have to—defray a portion of their advertising costs by partnering with lenders
 12 participating in the program. *Id.* ¶ 49. Lenders who agree to share the agent’s marketing costs
 13 “appear as ‘Premier Lenders’ in advertising alongside the agent” on Zillow’s applications and
 14 website. *Id.* ¶¶ 4-5.

15 In 2015, the Consumer Financial Protection Bureau (“CFPB”) dramatically stepped up
 16 enforcement of RESPA (*id.* ¶ 66), which was enacted to protect home buyers from “certain abusive
 17 practices that have developed” in the real estate industry, including ““kickbacks or referral fees
 18 that tend to increase unnecessarily the costs of [real estate] settlement services”” (*id.* ¶ 64 (quoting
 19 12 U.S.C. § 2601)). RESPA provides that “[n]o person shall give and no person shall accept any
 20 fee, kickback or thing of value” for the referral of federally insured mortgage loans. 12 U.S.C.
 21 § 2607(a). The statute contains a safe harbor for “the payment to any person of a bona fide salary
 22 or compensation or other payment for goods or facilities actually furnished or for services actually
 23 performed.” *Id.* § 2607(c).

24 Plaintiffs allege that the defendants concealed the fact that the CFPB had begun an
 25 investigation into Zillow’s co-marketing program in 2015, and the fact that Zillow redesigned the
 26 co-marketing program in 2017 to make it RESPA-compliant. Compl. ¶¶ 56, 68. Prior to that time,

according to plaintiffs, the co-marketing program violated RESPA: Plaintiffs allege that by accepting a share of marketing costs from lenders pursuant to the co-marketing program, and then posting advertising from the lender alongside Premier Agents, Zillow facilitated “kickbacks” between the agent and lender. *Id.* ¶ 55. They further allege that RESPA’s safe harbor does not apply because Zillow “permitted lenders to pay a greater share of the marketing budget than is justified by the number of leads provided by the [co-marketing] program.” *Id.* ¶ 59.

In the third quarter of 2017, Zillow announced that it was negotiating a settlement with the CFPB, and that the CFPB “intend[ed] to pursue further action if those discussions d[id] not result in a settlement.” *Id.* ¶ 13.² Zillow’s stock price dropped sharply on August 10, 2017. *Id.* ¶ 15. Attempting to capitalize on these losses, several shareholders sued Zillow, its CEO Spencer Rascoff, and its CFO Kathleen Philips, for securities fraud on behalf of a putative class of purchasers of Zillow stock from November 17, 2014 through August 8, 2017. Declaration of Matthew D. Ingber in Support of Motion to Dismiss Verified Consolidated Shareholder Complaint (“Ingber Decl.”) Ex. 1 ¶ 1. The complaint’s allegations are substantively identical to those here. This Court denied the defendants’ motion to dismiss the securities action on April 19, 2019. *In re Zillow Grp., Inc. Sec. Litig.*, No. 2:17-cv-01387-JCC (Dkt. # 54).

In October 2017, Matthew Sciabacucchi and Melvyn Klein brought this action on behalf of Zillow, alleging that they have been Zillow shareholders since August 2015 and February 2014, respectively. Compl. ¶¶ 21-22. The complaint asserts that (1) Zillow violated RESPA by permitting mortgage lenders to make illegal payments for referrals through the co-marketing program; (2) Zillow itself has already suffered “significant damages” as a result of the claimed misconduct; and (3) Zillow’s senior officers and virtually its entire Board should be required to pay damages to Zillow because of their alleged role in the claimed wrongdoing. *Id.* ¶¶ 4-18, 127.

² On June 25, 2018, Zillow filed a Form 8-K with the Securities and Exchange Commission disclosing that the CFPB had “completed its investigation” of Zillow and “that it did not intend to take enforcement action.” *See In re Zillow Grp., Inc. Sec. Litig.*, No. 2:17-cv-01387-JCC (Dkt. # 43 at 2).

1 Plaintiffs brought claims for breach of fiduciary duty (Counts I and II) and unjust enrichment
 2 (Count III) against Zillow, Rascoff, Philips, and seven directors discussed below. *Id.* ¶¶ 124-33.

3 Plaintiffs allege that they “have not made any demand on the present Board to institute this
 4 action because such a demand would be a futile, wasteful and useless act” (*id.* ¶ 115) because
 5 seven of the eight directors face a “substantial likelihood of liability” for the claimed fraud and/or
 6 lack independence due to purported business “entanglements” (*id.* ¶¶ 116-23). At the time the
 7 original derivative complaints were filed (October 23, 2017), Zillow’s Board had eight members:
 8 Rascoff (the CEO discussed above), Richard Barton, Erik Blachford, Lloyd Frink, Jay Hoag,
 9 Gregory Maffei, Gordon Stephenson, and April Underwood. *Id.* ¶¶ 24-33. Of these eight,
 10 plaintiffs contend that only one—Rascoff—perpetrated the alleged fraud or played any role in
 11 Zillow’s management. *See, e.g., id.* ¶¶ 67, 95, 112. For purposes of this motion, defendants
 12 concede that Rascoff, Barton, and Frink, are interested, inside directors. Plaintiffs, for their part,
 13 acknowledge that Underwood did not join the Zillow Board until February 2017; they do not name
 14 her as a defendant or dispute her ability to make a proper business judgment in response to a
 15 demand. *See id.* ¶ 33.

16 As to the four remaining outside directors who are the subject of this motion—Blachford,
 17 Hoag, Maffei, and Stephenson—plaintiffs allege that a demand for suit would be futile because
 18 these directors face a substantial likelihood of liability for the conduct alleged in the securities
 19 fraud complaint, and have outside business relationships with other interested directors. *Id.*
 20 ¶¶ 118-22.

21 **LEGAL STANDARDS**

22 Federal Rule of Civil Procedure 23.1 requires derivative complaints to state “with
 23 particularity” “any effort by the plaintiff to obtain the desired action from the directors” (a demand)
 24 or the “reasons for . . . not making the effort” (demand futility). This requirement is “designed to
 25 give a corporation the opportunity to rectify an alleged wrong without litigation, and to control
 26 any litigation which does arise.” *Braddock v. Zimmerman*, 906 A.2d 776, 784 (Del. 2006). The

1 law of the state of incorporation—here, Washington—establishes “the circumstances under which
 2 demand would be futile.” *In re Silicon Graphics, Inc. Sec. Litig.*, 183 F.3d 970, 989-90 (9th Cir.
 3 1999), superseded by statute on other grounds as stated in *Burbrink v. Campbell*, 734 F. App’x
 4 416 (9th Cir. 2018). When it comes to demand futility, Washington law “follows Delaware.” *In
 5 re F5 Networks, Inc.*, 207 P.3d 433, 439 (Wash. 2009) (en banc).

6 Delaware law imposes “stringent requirements of factual particularity” on plaintiffs who
 7 seek to excuse the failure to make a demand. *Brehm*, 746 A.2d at 254-55. Importantly, it is not
 8 enough for plaintiffs to make allegations about a company’s board or committee in general; they
 9 must plead particularized facts showing a disabling interest “specific to each director.” *Desimone
 10 v. Barrows*, 924 A.2d 908, 943 (Del. Ch. 2007); see also *In re infoUSA, Inc. S’holders Litig.*, 953
 11 A.2d 963, 985 (Del. Ch. 2007) (determination of director “[i]nterestedness” requires a “detailed,
 12 fact-intensive, director-by-director analysis”).

13 Delaware has established two tests to determine whether demand is excused. Under the
 14 *Aronson* test, if the plaintiffs challenge a *specific board decision*, demand is excused if the
 15 plaintiffs’ allegations create a reasonable doubt that (1) a majority of the directors is disinterested
 16 and independent, or (2) the transaction was the product of a valid exercise of business judgment.
 17 *Aronson*, 473 A.2d at 814. Where, as here, the complaint does not challenge a specific board
 18 decision, the *Rales* test applies and the second prong of *Aronson* does not: Plaintiffs must plead
 19 particularized facts that “create a reasonable doubt that . . . the board . . . could have properly
 20 exercised its independent and disinterested business judgment in responding to a demand.” *Rales
 21 v. Blasband*, 634 A.2d 927, 934 (Del. 1993). The Ninth Circuit has applied the *Rales* test to
 22 complaints alleging a failure to disclose information and a failure of oversight. See *Tindall v. First
 23 Solar Inc.*, 892 F.3d 1043, 1047-048 (9th Cir. 2018).

24 Plaintiffs can satisfy the *Rales* test through two alternative means: alleging interestedness
 25 or lack of independence. To allege interestedness, plaintiffs must plead particularized facts
 26 showing that a director faces a “substantial likelihood” of liability or “will receive a personal

1 financial benefit from a transaction that is not equally shared by the stockholders.” *Rales*, 634
 2 A.2d at 936. To allege lack of independence, plaintiffs must “plead facts that would support the
 3 inference that because of the nature of a relationship or additional circumstances other than the
 4 interested director’s stock ownership or voting power, the non-interested director would be more
 5 willing to risk his or her reputation than risk the relationship with the interested director.” *Beam*
 6 *v. Stewart*, 845 A.2d 1040, 1052 (Del. 2004). “[F]utility is gauged by the circumstances existing
 7 at the commencement of a derivative suit.” *Aronson*, 473 A.2d at 810.

8 These already steep pleading burdens are heightened where, as here, the corporation has
 9 an exculpation clause in its Articles of Incorporation waiving certain claims for money damages
 10 against directors. *See Ingber Decl. Ex. 2 art. 7; see also In re Coinstar Inc. S’holder Derivative*
 11 *Litig.*, 2011 WL 5553778, at *2 (W.D. Wash. Nov. 14, 2011) (court may take judicial notice of
 12 corporate charter). Washington law specifically “allows corporations to eliminate their directors’
 13 liability for nonintentional breaches of fiduciary duty.” *Fernandes v. Bianco*, 2006 WL 6862716,
 14 at *6 (W.D. Wash. June 22, 2006). Because shareholders who bring derivative suits step into the
 15 corporation’s shoes, they are bound by this waiver. In such circumstances, a “serious threat of
 16 liability may only be found to exist if the plaintiff pleads a *non-exculpated* claim against the
 17 directors based on particularized facts.” *Guttman v. Huang*, 823 A.2d 492, 501 (Del. Ch. 2003).
 18 This means that plaintiffs may demonstrate a substantial likelihood of a director’s liability only by
 19 pleading particularized facts that, if proven, would “show that a majority of the [directors]
 20 *knowingly* engaged in [wrongful] conduct.” *Wood v. Baum*, 953 A.2d 136, 141 (Del. 2008)
 21 (emphasis added). If a derivative plaintiff fails to meet this burden, the complaint must be
 22 dismissed even if the claim appears otherwise meritorious. *Haber v. Bell*, 465 A.2d 353, 357 (Del.
 23 Ch. 1983).

24 ARGUMENT

25 Plaintiffs have failed to plead particularized facts showing that Zillow’s Board could not
 26 make a proper business judgment in response to a demand to sue. First, their complaint does not

1 adequately allege that Zillow’s outside directors were subject to a substantial likelihood of personal
 2 liability; it alleges neither that the directors knew that they were not discharging their oversight
 3 duties nor that they deliberately misinformed shareholders that the co-marketing program
 4 complied with all legal and regulatory requirements. Second, plaintiffs have not alleged that the
 5 outside directors lacked independence; they have not claimed that these directors had any close
 6 financial ties to any interested director, or that any relationship with the interested directors caused
 7 the outside directors “to act non-independently” “in the past.” *Beam*, 845 A.2d at 1051.

8 **I. PLAINTIFFS HAVE NOT PLEADED PARTICULARIZED FACTS SHOWING
 9 THAT ZILLOW’S OUTSIDE DIRECTORS ARE SUBJECT TO A SUBSTANTIAL
 LIKELIHOOD OF LIABILITY.**

10 Plaintiffs allege that the four outside directors at issue face a substantial likelihood of
 11 liability for four main reasons: (a) the Court denied the defendants’ motion to dismiss the securities
 12 class action complaint; (b) the directors exercised “control” over the alleged wrongdoing; (c) three
 13 of the directors were members of Zillow’s Audit Committee; and (d) all four failed to properly
 14 supervise Zillow’s internal controls. Each of these allegations is insufficient.

15 **A. This Court’s Decision In The Securities Suit Is Irrelevant To Whether The
 16 Outside Directors Face A Substantial Likelihood Of Liability.**

17 The complaint relies heavily on the fact that the Court denied defendants’ motion to dismiss
 18 the securities action. *See, e.g.*, Compl. ¶¶ 107-12. This Court held, for example, that the securities
 19 complaint adequately alleged that Philips’ statements were materially misleading “for failing to
 20 disclose that the comarketing program was designed to facilitate RESPA violations and for failing
 21 to disclose that Zillow had changed the program in response to the CFPB’s investigation.” *Id.*
 22 ¶ 112. The Court also determined that the securities complaint adequately alleged that “Rascoff’s
 23 statement that ‘[w]e think the way we’ve constructed the program is completely compliant . . . was
 24 materially misleading because it omitted that Zillow designed the co-marketing program to allow
 25 agents and lenders to violate RESPA.” *Id.*; *see also id.* ¶ 111.

1 The complaint is notably silent, however, on how the *outside* directors would have known
 2 that Philips' or Rascoff's statements were false. This Court held in the securities action only that
 3 the plaintiffs had adequately alleged scienter with respect to Zillow's CEO and CFO. Even if that
 4 conclusion were extended to all of Zillow's *officers*, plaintiffs were required to plead facts showing
 5 that at least one of the outside *directors* acted with scienter. *See Wood*, 953 A.2d at 141. Plaintiffs
 6 have not alleged a single fact to support this conclusion.

7 Because they typically involve different defendants, courts have routinely dismissed
 8 shareholder derivative suits that piggyback on securities fraud complaints, even when the securities
 9 complaints have withstood a motion to dismiss. In *BofI Holding*, for example, the court had
 10 previously held that a securities fraud complaint pleaded sufficient facts to give rise to a strong
 11 inference that the company's CEO acted with scienter. 2017 WL 784118, at *14-15. This
 12 decision, however, had "virtually no probative value in the demand futility context" because the
 13 CEO was only one of nine directors and the court had not found that a "strong inference of scienter
 14 attached to any of the eight remaining director defendants." *Id.* at *14. The court held that the
 15 derivative complaint had to be dismissed because the plaintiffs failed to plead that any of the
 16 outside directors "would have known that there were false and misleading statements" in the
 17 company's SEC filings. *Id.* It "reject[ed] Plaintiffs' attempt to rely on the mere existence of
 18 wrongdoing occurring somewhere at the company as evidence of the Board's knowledge or
 19 complicity in that wrongdoing." *Id.* at *15; *see also Stone ex rel. AmSouth Bancorporation v.*
 20 *Ritter*, 911 A.2d 362, 372 (Del. 2006) (affirming dismissal of derivative complaint, and stating
 21 that "most of the decisions that a corporation, acting through its human agents, makes are, of
 22 course, not the subject of director attention." (quoting *In re Caremark*, 698 A.2d at 968));
 23 *Seminaris v. Landa*, 662 A.2d 1350, 1355 (Del. Ch. 1995). The same analysis applies here:
 24 Because plaintiffs have not shown that the "alleged wrongdoing pierced the confines of the
 25 Boardroom," *BofI Holding*, 2017 WL 784118, at *15, they cannot benefit from this Court's
 26

decision on the securities class action to demonstrate that the outside directors face a substantial likelihood of liability.

B. Plaintiffs Do Not Explain How The Directors Exercised “Control” Over The Conduct Alleged In The Securities Action.

Plaintiffs baldly assert that, “because of their positions of control and authority as directors . . . of Zillow,” the defendants “were able to and did, directly and/or indirectly, exercise control over the wrongful acts” alleged in the securities suit. Compl. ¶ 38. The complaint offers no explanation as to how they exercised this control, much less allege these facts on a particularized “director-by-director” basis. *InfoUSA.*, 953 A.2d at 985.

The closest thing to an explanation comes in Paragraph 118 of the complaint, where plaintiffs allege that each of the outside directors “signed [a] false and misleading 2015 10-K and 2016 10-K, which falsely represented that [Zillow] was in compliance with all government regulations.” Compl. ¶ 118; *see also id.* ¶ 126 (alleging that the directors “caus[ed] or allow[ed] the Company to disseminate to Zillow shareholders materially misleading and inaccurate information through, *inter alia*, SEC filings, press releases, conference calls, and other public statements and disclosures”). Delaware courts have rejected practically identical allegations. In *Wood*, for example, the court held that “[t]he Board’s execution of [the corporation’s] financial reports, without more, is insufficient to create an inference that the directors had actual or constructive notice of any illegality.” 953 A.2d at 142. And in *In re Citigroup Inc. Shareholder Derivative Litigation*, 964 A.2d 106 (Del. Ch. 2009), the court explained that “[p]leading that the director defendants ‘caused or allowed’ the Company to issue certain statements is not sufficient[ly] particularized pleading to excuse demand under Rule 23.1.” *Id.* at 133 n.88. Courts in this District have confirmed that “[o]utside directors are not typically held liable for allegedly false or misleading information conveyed in prospectuses, registration statements, annual reports, press releases, or other group-published information.” *Fernandes*, 2006 WL 6862716, at *4.

Plaintiffs also allege that the directors “were aware of or reckless towards the [co-marketing program] because Zillow actively tracked the number of referrals premiere [sic] agents provided to lenders,” and the defendants “were also aware that the Co-Marketing Program was not subject to the safe harbor because it had data that showed that agents paid far in excess of reasonable market rates for co-marketing advertising.” Compl. ¶ 65. Plaintiffs do not identify any source of such “data,” let alone allege that any “internal company metrics or information [were] discussed at the Board level.” *In re Accuray, Inc. S’holder Derivative Litig.*, 757 F. Supp. 2d 919, 928 (N.D. Cal. 2010) (emphasis added). Plaintiffs cannot show that the outside directors had “substantial likelihood” of liability without explaining *what* any of these defendants knew or believed about the co-marketing program, *when* and *how* they acquired this purported information, or anything suggesting that they knowingly drafted or approved false or misleading statements. Such information—“allegations regarding what the directors knew and when”—is “crucial” to “establish a threat of director liability” in this context. *Citigroup*, 964 A.2d at 133-34 & n.88; *see also Murashko v. Hammer*, 2018 WL 1022575, at *5 (D.N.J. Feb. 22, 2018) (“To establish a threat of director liability based on a disclosure violation, plaintiffs must plead facts that show that the violation was made knowingly or in bad faith, a showing that requires allegations regarding what the directors knew and when.”) (internal quotation marks and alterations omitted).

C. Membership On Zillow's Audit Committee Does Not Give Rise To A Substantial Likelihood Of Liability.

Plaintiffs allege next that three of the outside directors—Blachford, Maffei, and Stephenson—face a substantial likelihood of liability by virtue of their membership on Zillow’s Audit Committee. Compl. ¶ 119. They assert that “[t]he Audit Committee Charter specifically charges the members of the Audit Committee with ensuring the compliance with legal and regulatory requirements,” and that these defendants “fail[ed] to take adequate steps to ensure such compliance.” *Id.* Plaintiffs also allege that because Blachford and Maffei were on the Audit

1 Committee at the time the CFPB began its investigation, they “were specifically put on notice of
 2 potential [RESPA] violations in 2015.” *Id.* ¶ 120; *see also id.* ¶¶ 40-41.

3 These allegations are nothing more than a restatement of the fact that the directors were *on*
 4 the Audit Committee. And “[c]ourts applying Delaware case law have consistently held . . . that
 5 a director is not interested merely by virtue of sitting on an Audit Committee.” *In re Coca-Cola*
 6 *Enter., Inc. Derivative Litig.*, 478 F. Supp. 2d 1369, 1378 (N.D. Ga. 2007), *aff’d sub nom. Staehr*
 7 *v. Alm*, 269 F. App’x 888 (11th Cir. 2008); *see also, e.g., Murashko*, 2018 WL 1022575, at *5
 8 (“[I]t is well-settled that membership, alone, on an Audit Committee is an insufficient basis for
 9 inferring scienter.”); *Wood*, 953 A.2d at 142 (“Plaintiff [] asserts that membership on the Audit
 10 Committee is a sufficient basis to infer the requisite scienter. That assertion is contrary to well-
 11 settled Delaware law.”); *Pirelli Armstrong Tire Corp. Retiree Med. Ben. Tr. v. Lundgren*, 579 F.
 12 Supp. 2d 520, 532 (S.D.N.Y. 2008) (dismissing derivative complaint for failure to plead demand
 13 futility, and stating “[t]he Complaint does allege that the members of the Audit Committee were
 14 responsible for ‘reviewing and discussing . . . the Company’s earnings press releases, . . . financial
 15 information and earnings guidance . . . and . . . disclosure and internal controls.’ . . . However,
 16 these general allegations, based simply on the fact that a defendant was a member of a board or
 17 committee, without more, are insufficient as a matter of law” to show substantial likelihood of
 18 liability).

19 Nor is it relevant whether the outside directors violated Zillow’s Audit Committee Charter.
 20 *See Compl.* ¶ 119. “[D]irector liability is not measured by the aspirational standard established
 21 by . . . internal documents.” *Citigroup*, 964 A.2d at 135; *see also Accuray*, 757 F. Supp. 2d at 929
 22 (same). The question is whether, as Audit Committee members, the outside directors were
 23 substantially likely to have knowledge of the wrongdoing alleged in the complaint and then failed
 24 to do anything about it. And Delaware law is clear that mere membership, without more, does not
 25 establish such knowledge in the context of demand futility.

1 **D. Plaintiffs Have Not Stated A *Caremark* Claim.**

2 Plaintiffs also make a boilerplate allegation that the directors “fail[ed] to maintain internal
 3 control.” Compl. at 34. This allegation is known as a *Caremark* claim, which “is possibly the
 4 most difficult theory in corporate law upon which a plaintiff might hope to win a judgment.” 698
 5 A.2d at 967. To prevail, plaintiffs must demonstrate that the directors “had clear notice” of
 6 improprieties and “simply chose to ignore them” or affirmatively “encourage[ed] their
 7 continuation.” *Guttmann*, 823 A.2d at 507; *see also Desimone*, 924 A.2d at 935 (“For reasons
 8 *Caremark* well-explained, to hold directors liable for a failure in monitoring, the directors have to
 9 have acted with a state of mind consistent with a conscious decision to breach their duty of care.”).
 10 “[O]nly a sustained or systematic failure of the board to exercise oversight . . . will establish the
 11 lack of good faith that is a necessary condition to liability.” *Caremark*, 698 A.2d at 971.

12 The complaint fails to plead *any* systematic failure of oversight. Plaintiffs do not explain
 13 how Zillow’s oversight mechanisms were inadequate, how the directors would have known of
 14 these inadequacies, or that they consciously ignored them. Instead, plaintiffs rely solely on their
 15 oft-repeated (but always unsubstantiated) allegation that the directors must have been aware of the
 16 misrepresentations simply because they sat on the Board. *See, e.g.*, Compl. ¶ 38. That theory is
 17 exactly what *Caremark* forbids. *See Citigroup*, 964 A.2d at 129 (dismissing complaint where
 18 “plaintiffs[] repeatedly ma[de] the conclusory allegation that the defendants have breached their
 19 duty of oversight,” but did not “adequately explain what the director defendants actually did or
 20 failed to do that would constitute such a violation”).

21 **II. PLAINTIFFS HAVE NOT PLEADED PARTICULARIZED FACTS SHOWING
 22 THAT ZILLOW’S OUTSIDE DIRECTORS LACKED INDEPENDENCE.**

23 Plaintiffs have also failed to meet the second alternative prong of the *Rales* test: they do
 24 not sufficiently allege that the outside directors lack the independence to consider a demand.

25 Delaware law presumes a director’s independence. *Beam*, 845 A.2d at 1050. To defeat
 26 this presumption, a complaint “must create a reasonable doubt that a director is not so ‘beholden’

1 to an interested director . . . that his or her ‘discretion would be sterilized.’” *Id.* (quoting *Rales*,
 2 634 A.2d at 936). Plaintiffs offer three reasons why Zillow’s outside directors lacked
 3 independence to consider a demand. Each is meritless.

4 Plaintiffs first allege that Maffei and Blachford³ lack independence because, along with
 5 Rascoff and Barton (who are interested parties), they each invested in unaffiliated venture capital
 6 funds through Technology Crossover Ventures. Compl. ¶ 121. That is as thin as it gets.
 7 “[A]llegations of ‘a mere outside business relationship,’ standing alone, are insufficient to raise a
 8 reasonable doubt about a director’s independence.” *Accuray*, 757 F. Supp. 2d at 930-931 (rejecting
 9 allegations that “certain ‘long term relationships’ rendered three of the outside directors
 10 dependent”) (quoting *Beam*, 845 A.2d at 1050); *accord In re Verisign, Inc. Derivative Litig.*, 531
 11 F. Supp. 2d 1173, 1200 (N.D. Cal. 2007) (no lack of independence where plaintiffs “plead no facts
 12 showing interlocking financial obligations, no facts demonstrating that any director is dominated
 13 by an [inside] officer or director . . . , and no facts establishing that any director is so ‘beholden’
 14 to a controlling director or majority shareholder”). And plaintiffs’ allegation is not even fairly
 15 characterized as a “business relationship.” All they claim is that the two outside directors invested
 16 in the same funds as Rascoff and Barton; they do not even allege that Maffei and Blachford were
 17 *aware* of this connection.

18 Second, plaintiffs argue that Stephenson is dependent because he “participates in Zillow
 19 Group’s Premier Agent program.” Compl. ¶ 122. That is irrelevant. As discussed above (at 3),
 20 Premier Agents are given a “[s]uite of marketing and business technology solutions to help real
 21 estate agents and brokerages grow their businesses and brands” (Compl. ¶ 48 (emphasis added)),
 22 and the co-marketing program is simply one component of the overall Premier Agent program.
 23 Plaintiffs do not allege that the Premier Agent product violated RESPA; their only allegations
 24

25 ³ Plaintiffs do not allege that Hoag lacks independence as a result of being a “direct or
 26 indirect director, limited partner, or member of the general partners of the TCV Funds.” Compl.
 ¶ 121. Even if they did, plaintiffs have not pleaded with particularity any facts that would cast
 Hoag’s independence into doubt.

1 pertain to the co-marketing program. And the complaint does not allege that Stephenson engaged
 2 in any co-marketing. His status as a Premier Agent tells us nothing about his ability to impartially
 3 consider a demand to litigate the company's alleged misrepresentations about the co-marketing
 4 program.

5 Third, plaintiffs assert that Stephenson "is the Managing Partner of Real Property
 6 Associates, which provides certain brokerage and rental management services to Defendant
 7 Rascoff." *Id.* ¶ 122. Again, "the simple fact that there are some financial ties between the
 8 interested party and the director is not disqualifying"; plaintiffs had to explain why these ties
 9 prevented Stephenson from "objectively fulfill[ing] his fiduciary duties." *In re MFW S'holders*
 10 *Litig.*, 67 A.3d 496, 509 (Del. Ch. 2013). In *In re Friedman's, Inc. Derivative Litigation*, 386 F.
 11 Supp. 2d 1355 (N.D. Ga. 2005), the plaintiff shareholders alleged that one of the directors lacked
 12 independence "because his company provide[d] insurance brokerage and employee benefits
 13 consulting services to both" the defendant company and an affiliated entity. *Id.* at 1368. The court
 14 rejected this claim because the complaint did "not allege any specific facts establishing the terms
 15 of the relationship between" the two companies. *Id.* The same is true here. The complaint "set[s]
 16 forth no particularized allegations of compensation actually received by [Stephenson] in return
 17 for" providing services to Rascoff, "or as to whether such compensation would be material to a
 18 director in [Stephenson's] position." *Khanna v. McMinn*, 2006 WL 1388744, at *20 (Del. Ch.
 19 May 9, 2006). That omission dooms plaintiffs' argument.

20 **III. PLAINTIFFS HAVE NOT PLEADED PARTICULARIZED FACTS SHOWING
 21 THAT THE BOARD COULD NOT MAKE A PROPER BUSINESS JUDGMENT IN
 22 RESPONSE TO A DEMAND THAT THE COMPANY PURSUE A CLAIM FOR
 23 UNJUST ENRICHMENT.**

24 In Count III of the complaint, plaintiffs seek restitution, on behalf of Zillow, "of all profits,
 25 benefits, and other compensation obtained by Defendants." Compl. ¶ 133. This claim appears to
 26 be predicated on the assumption that the defendants breached their fiduciary duties as claimed in

Counts I and II. Because plaintiffs failed to show that demand was futile on Counts I and II, it necessarily follows that they have failed to properly allege demand futility as to Count III as well.

To the extent Count III is based on a claim of excessive compensation, it also fails for lack of specificity. Plaintiffs offer no allegations about the compensation Zillow paid to any of the defendants. Excessive compensation claims can be brought derivatively under a theory of waste, but first the plaintiffs must identify “whose compensation should be deemed excessive and wasteful.” *In re Dow Chem.*, 2010 WL 66769, at *14 n.88 (Del. Ch. Jan. 11, 2010). And then plaintiffs must meet the “stringent requirements for [pleading] waste.” *Id.* Plaintiffs have not done either here. Thus, if plaintiffs are seeking to recover allegedly excessive compensation from some unidentified defendants, the complaint fails to state a claim or show that demand would be futile.

CONCLUSION

The complaint should be dismissed.

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CERTIFICATE OF SERVICE

I hereby certify that on the 22nd day of August 2019, a copy of the foregoing Defendants' Motion to Dismiss the Verified Consolidated Shareholder Derivative Complaint was filed electronically and served by mail on anyone unable to accept electronic filing. Notice of this filing will be sent via e-mail to all parties by operation of the court's electronic filing system or by mail to anyone unable to accept electronic filing as indicated on the Notice of Electronic Filing. Parties may access this filing through the court's CM/ECF System.

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